

REPORT OF EXAMINATION
OF THE
FINANCIAL INDEMNITY COMPANY

AS OF
DECEMBER 31, 2005

Participating State
and Zone:

California

Filed May 21, 2007

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Los Angeles, California
May 3, 2007

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Kent Michie
Secretary, Zone IV-Western
Commissioner of Insurance
Department of Insurance, State of Utah
Salt Lake City, Utah

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

FINANCIAL INDEMNITY COMPANY

(hereinafter also referred to as the Company) at its home office located at 10650 Oxnard Street, Suite 1800, Woodland Hills, California 91367.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2002. This examination covers the period from January 1, 2003 through December 31, 2005. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2005, as deemed necessary under the circumstances.

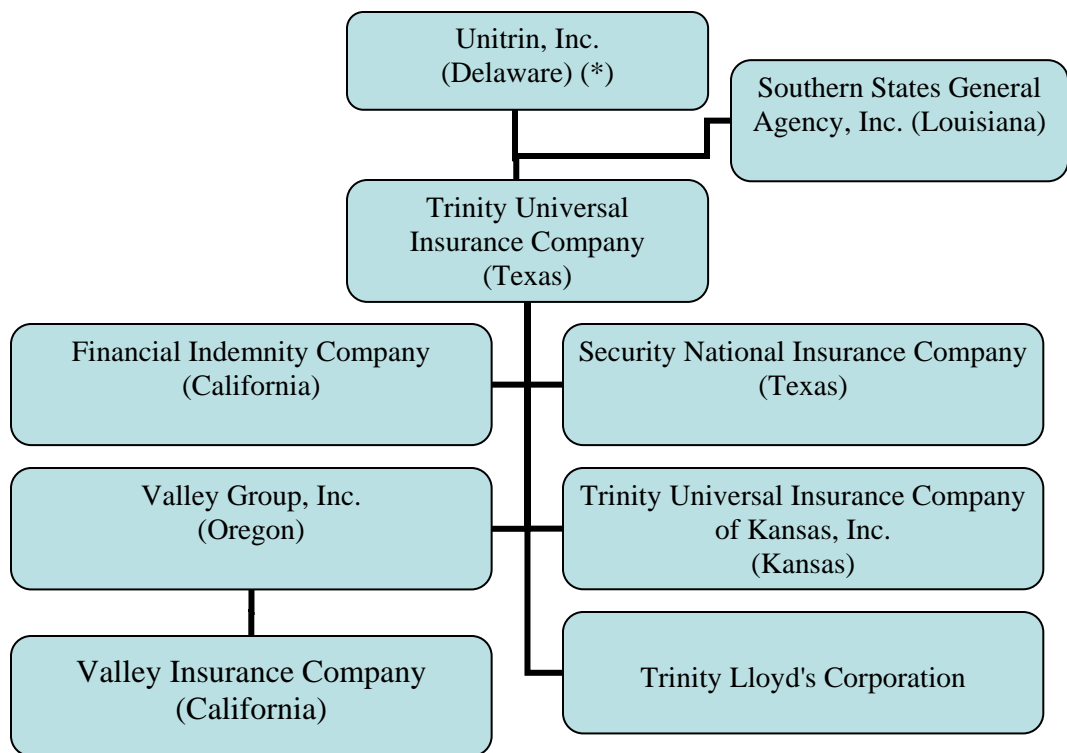
In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

COMPANY HISTORY

The Company paid a \$3 million dividend to its parent, Trinity Universal Insurance Company, in 2004. The dividend was comprised of cash and preferred stock with a market value of \$2.9 million. In 2005 the Company paid an additional \$3 million cash dividend to its parent.

MANAGEMENT AND CONTROL

The Company is a wholly-owned subsidiary of Trinity Universal Insurance Company (Trinity), a stock insurance company domiciled in Texas. Trinity is a wholly-owned subsidiary of the ultimate parent, Unitrin, Inc., a Delaware Corporation. The following abridged organizational chart, which is limited to the ultimate parent and its subsidiary insurance companies, depicts the Company's relationship within the holding company system:



(*) all ownership is 100%

Management of the Company is vested in a five-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2005 follows:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
David F. Bengston Woodstock, Illinois	Vice President Unitrin, Inc.
Eric J. Draut Arlington Heights, Illinois	Executive Vice President and Chief Financial Officer Unitrin, Inc.
John W. Mullen McKinney, Texas	President Financial Indemnity Company
Richard Roeske Naperville, Illinois	Vice President and Chief Accounting Officer Unitrin, Inc.
Donald G. Southwell Wayne, Illinois	President and Chief Operating Officer Unitrin, Inc.

Principal Officers

<u>Name</u>	<u>Title</u>
Donald G. Southwell	Chairman of the Board
John W. Mullen	President
Edward D. Cimini, Jr.	Senior Vice President and Actuary
David B. Piper	Senior Vice President – Underwriting Services
Lisa K. Bage	Senior Vice President and Secretary
Philip R. Lombardo	Vice President and Treasurer

Management Agreements

General Service Agreement: On January 1, 1997, the Company entered into a General Service Agreement with its affiliate, Unitrin Services Company (Unitrin Services). Under the terms of the agreement, the Company receives the following services from Unitrin Services: executive

management, trade execution and investment analysis, investment and financial accounting and reporting, purchasing and accounts payable, tax return preparation, tax accounting and advice, maintenance of benefit plan, risk management, internal auditing, financial planning, real estate management, legal advice and corporate management information systems support and advice. The Company reimburses Unitrin Services for actual expenses incurred. For 2005, 2004 and 2003, the Company paid \$4,329,112, \$6,277,351, and \$6,088,031, respectively, in fees to Unitrin Services for its services. An amendment to the agreement, extending the term for an indefinite period beginning January 1, 2000, was approved by the California Department of Insurance (CDI) on November 10, 1999.

Computer Service Agreement: On December 31, 1996, the Company entered into a Computer Service Agreement with Unitrin Services. Under the terms of the agreement, Unitrin Services provides the Company with the following: computer data processing services using computer systems maintained by Unitrin Services, consulting services relating to acquisition and installation of equipment or software, and the purchase of computer hardware on behalf of the Company. The Company is charged for its proportionate share of the cost of maintaining and operating the systems based on the Company's actual usage. For 2005, 2004, and 2003, the Company paid \$1,588,195, \$1,418,158, and \$1,324,226, respectively, in fees to Unitrin Services under the terms of this agreement. An amendment to the agreement, extending the term for an indefinite period beginning January 1, 2000, was submitted to the CDI and approved on November 10, 1999.

Federal Income Tax Agreement: On November 6, 1995, the Company entered into a Federal Income Tax Agreement with its ultimate parent, Unitrin, Inc. (Unitrin). The agreement established the method of settlement of federal income tax payments and refunds between Unitrin and its subsidiaries. Under the terms of the agreement, the Company pays to, or receives from, Unitrin an amount of tax it would owe, or be refunded, from the Internal Revenue Service as if the Company was filing a separate federal income tax return. The tax agreement has been amended various times to add other companies. Each of these amendments were made after January 1, 1997, and are

subject to the prior approval requirements of California Insurance Code (CIC) Section 1215.5(b)(4). It is recommended that the Company submit the amendments to the CDI for approval.

Administrative Services Agreement: On January 1, 2002, the Company entered into a General Services Agreement with its parent, Trinity Universal Insurance Company (Trinity) and an affiliate, Valley Insurance Company (VIC). Under the terms of the agreement, Trinity (through its subsidiary Valley Property and Casualty Insurance Company) provides the Company with the following administrative services for business conducted in Oregon: marketing, underwriting, negotiation of reinsurance, loss, claim expenses, attorney appointments, loss reporting, collect and deposit Company funds in a Trinity account, maintain records and documents, provides data processing and accounting services and regulatory compliance. The Company reimburses Trinity for the Company's proportionate share of the actual and reasonable costs. For 2005, 2004 and 2003, the Company paid \$4,434,903, \$4,367,640, and \$1,064,804, respectively, in fees to Trinity. The Company received approval for this agreement from the CDI on March 1, 2001.

CORPORATE RECORDS

California Insurance Code (CIC) Section 735 states that the Company must inform the board members of the receipt of the examination report. The board should be informed of the report both in the form first formally prepared by the examiners and in the form as finally settled and officially filed by the commissioner. The board must also enter that fact in the board minutes. A review of the board minutes disclosed that, while the officially filed report was presented to the board, the first formally prepared draft by the examiners was not. It is recommended that the Company implement procedures to ensure future compliance with CIC Section 735.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2005, the Company was licensed to transact business in the following twenty-one states:

Alabama	Indiana	Oregon
Arizona	Louisiana	Tennessee
California	Missouri	Texas
Colorado	Montana	Utah
Delaware	Nevada	Washington
Idaho	New Mexico	Wisconsin
Illinois	Ohio	Wyoming

The Company's business is written through approximately 9,000 independent agents. The principal line of business written is nonstandard automobile liability and physical damage coverage on private and commercial vehicles. In 2005, direct premiums written were \$290.1 million. For the year ended December 31, 2005, the five largest premium volume states were as follows:

<u>State</u>	<u>Direct Premiums Written</u>	<u>Percentage of Total</u>
California	\$ 141,920,766	48.92%
Washington	\$ 32,519,730	11.21%
Louisiana	\$ 17,674,056	6.09%
Oregon	\$ 17,053,527	5.88%
Utah	\$ 16,599,022	5.72%

All of the Company's underwriting files, claims files, policy maintenance, and the majority of the claims processing is handled at the Company's home office in Woodland Hills, California. The Company's accounting and finance functions are performed in Dallas, Texas, except for certain investment, tax and treasury functions, which are performed in Chicago, Illinois by Unitrin Services Company. The Company currently maintains branch offices in Salem, Oregon and Dallas, Texas.

REINSURANCE

Assumed

Prior to January 1, 2005 the Company assumed all business written in Texas from Southern County Mutual Insurance Company, an affiliate of Republic Insurance Company. The Company and an affiliate, Unitrin County Mutual Insurance Company (UCM), entered into a quota share reinsurance agreement effective January 1, 2000. Under the terms of the agreement, the Company assumed 100% of UCM's Texas policies classified as personal lines automobile insurance, written under certain specifically defined programs, motorcycle insurance and commercial insurance. Effective January 1, 2005, the Company is no longer party to this quota share reinsurance agreement with UCM. The treaty is currently in run-off.

Ceded

The principal treaties, retentions and ceded limits in effect at December 31, 2005 are set forth as follows:

Type of Contracts	Reinsurers' Name	Reinsurer Percentage	Reinsurer. Maximum Limits	Company's Retention	Reinsurers' Total Maximum Limits
<u>Per Risk Excess of Loss</u>					
First Layer Excess of Loss	Axis Reinsurance Co.	10.0%	\$ 400,000	\$1 million each loss occurrence	\$4 million excess of \$1 million each loss occurrence
	Catlin Insurance Co. Ltd.	5.0%	200,000		
	Endurance Specialty Ins. Ltd.	10.0%	400,000		
	Lloyds of London	75.0%	3,000,000		
Second Layer Excess of Loss	Axis Reinsurance Co. Lloyds of London	20.0% 80.0%	\$ 4,000,000 16,000,000	\$5 million each loss occurrence	\$15 million excess of \$5 million each loss Occurrence
<u>Per Occurrence Excess of Loss</u>					
First Layer Property Catastrophe Excess of Loss	American Agricultural Ins. Co.	5.0%	\$ 300,000	\$4 million each loss occurrence	\$6 million excess of \$4 million each loss Occurrence
	Aspen Reinsurance. Ltd.	10.0%	600,000		
	DaVinci Reinsurance. Ltd.	5.0%	300,000		
	Renaissance Reinsurance Ltd.	5.0%	300,000		
	XL Re Ltd.	15.0%	900,000		
	Lloyds of London	60.0%	3,600,000		

Type of Contracts	Reinsurers' Name	Reinsurer Percentage	Reinsurer. Maximum Limits	Company's Retention	Reinsurers' Total Maximum Limits
Second Layer Property Catastrophe Excess of Loss	American Agricultural Ins. Co.	5.0%	\$ 500,000	\$10 million each loss occurrence	\$10 million excess of \$10 million each loss occurrence
	Transatlantic Reinsurance Co.	15.0%	1,500,000		
	Ace Tempest Reinsurance Co.	7.5%	750,000		
	Aspen Reinsurance Ltd.	7.5%	750,000		
	DaVinci Reinsurance. Ltd.	5.0%	500,000		
	Renaissance Reinsurance Ltd.	5.0%	500,000		
	XL Re Ltd.	10.0%	1,000,000		
	Lloyds of London	45.0%	4,500,000		
Third Layer Property Catastrophe Excess of Loss	American Agricultural Ins. Co.	2.0%	\$ 400,000	\$20 million each loss occurrence	\$20 million excess of \$20 million each loss occurrence
	Ace Tempest Reinsurance Co.	25.0%	5,000,000		
	Aspen Reinsurance Ltd.	7.5%	1,500,000		
	DaVinci Reinsurance Ltd.	5.0%	1,000,000		
	MS Frontier Reinsurance Ltd.	5.0%	1,000,000		
	Renaissance Reinsurance Ltd.	5.0%	1,000,000		
	XL Re Ltd.	10.0%	2,000,000		
	Lloyds of London	40.5%	8,100,000		
<u>Quota Share</u>					
Quota Share	Trinity Universal Insurance Co.	N/A	N/A	10% of all inforce and newly issued policies	90% of all inforce and newly issued policies

ACCOUNTS AND RECORDS

A review of the previously noted quota share reinsurance agreement with Trinity Universal Insurance Company (Trinity) disclosed that, as part of the administration of the agreement, Trinity collects all premiums, including the Company's, and deposits these premiums into a Trinity account in Texas. The deposit of the Company's premiums into a Trinity account outside the State of California is contrary to California Insurance Code (CIC) Section 1100 and CIC Section 1104.1. CIC Section 1100 requires all investments and deposits of the assets of an insurer, all purchases on behalf of an insurer, and all sales made of the property and effects of an insurer shall be made in its own name, or in that of a corporation authorized to act as a trustee under California laws. CIC Section 1104.1 requires that Company assets be deposited in an approved California custodial account. It is recommended that the Company and its parent comply with CIC Sections 1100 and 1104.1.

In addition, a review of Trinity's most recent Examination Report prepared by the Texas Department of Insurance, disclosed several material accounting deficiencies that directly impact the Company. These deficiencies included the lack of proper documentation to support many of its affiliated transactions and account balances, including funds held under reinsurance agreements, receivables and payables from and to affiliates and outstanding checks. The report also noted that many of the account reconciliations were not prepared on a regular basis.

In June 2005, the Company's ultimate parent, Unitrin, Inc. submitted a corrective action plan to the Texas Department of Insurance. The plan addressed the above deficiencies and included the following corrective actions that have or will be taken:

- Unitrin established a new unit dedicated solely for Trinity's financial reporting and state insurance department financial affairs. This unit will develop the documentation to support all transactions.
- The reconciliation process and procedures were reviewed and improved. Staff was added and additional training was provided to enhance the reconciliation process.
- Trinity provided educational training on accounting and disclosures relating to transactions with affiliates and other non-related parties to, along with the training to improve reconciliation procedures, resolve the inadequate documentation issues.

It is recommended that the Company follow up on these corrective actions to insure they are implemented properly and in a timely manner.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2005

Underwriting and Investment Exhibit for the Year Ended December 31, 2005

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2005

Statement of Financial Condition
as of December 31, 2005

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 51,043,266	\$	\$ 51,043,266	
Stocks:				
Preferred stocks	262,000		262,000	
Cash and cash equivalents	6,890,519		6,890,519	
Investment income due and accrued	674,536		674,536	
Premiums and considerations:				
Uncollected premiums and agents' balances in the course of collection	6,005,154		6,005,154	
Reinsurance:				
Amounts recoverable from reinsurers	543,411		543,411	
Other amounts receivable under reinsurance contracts	10,809		10,809	
Net deferred tax asset	1,710,906	299,062	1,411,844	
Guaranty funds receivable or on deposit	511,730		511,730	
Receivable from parent, subsidiaries and affiliates	577,777		577,777	
Aggregate write-ins for other than invested assets	<u>63,597</u>	<u>63,597</u>	<u>0</u>	
Total assets	<u>\$ 68,293,704</u>	<u>\$ 362,659</u>	<u>\$ 67,931,045</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 14,424,102	(1)
Loss adjustment expenses			2,908,810	(1)
Taxes, licenses and fees			1,419,768	
Current federal and foreign income taxes			3,854,934	
Unearned premiums			9,081,633	
Provision for reinsurance			<u>475,368</u>	
Total liabilities			32,164,615	
Common capital stock		\$ 2,600,000		
Gross paid-in and contributed surplus		5,334,000		
Unassigned funds (surplus)		<u>27,832,430</u>		
Surplus as regards policyholders			<u>35,766,430</u>	
Total liabilities, surplus and other funds			<u>\$ 67,931,045</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2005

Statement of Income

Underwriting Income

Premiums earned		\$ 31,575,496
Deductions:		
Losses incurred	\$ 13,556,009	
Loss expense incurred	2,614,941	
Other underwriting expenses incurred	<u>7,611,815</u>	
Total underwriting deductions		<u>23,782,766</u>
Net underwriting gain		7,792,730

Investment Income

Net investment income earned	\$ 2,541,879	
Net realized capital gains	<u>2,073</u>	
Net investment gain		2,543,952

Other Income

Net loss from agents' or premiums balances charged off	(669,020)	
Finance and service charges not included in premiums	<u>\$ 1,541,418</u>	
Total other income		<u>872,399</u>
Net income before federal income taxes		11,209,081
Federal income taxes incurred		<u>544,145</u>
Net income		<u>\$ 7,664,936</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2004		\$ 30,970,373
Net income	\$ 7,664,936	
Change in net unrealized capital losses	(2,759)	
Change in net deferred income tax	291,608	
Change in nonadmitted assets	(106,716)	
Change in provision for reinsurance	(51,012)	
Dividends to stockholders	<u>(3,000,000)</u>	
Change in surplus as regards policyholders		<u>4,796,057</u>
Surplus as regards policyholders, December 31, 2005		<u>\$ 35,766,430</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2005

Surplus as regards policyholders, December 31, 2002, per Examination			\$ 27,086,080
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 13,012,430	\$	
Net unrealized capital losses		78,261	
Change in net deferred income tax	597,439		
Change in nonadmitted assets	155,280		
Change in provision for reinsurance	201,716		
Dividends to stockholders		6,000,000	
Aggregate write-ins for gains in surplus	<u>791,746</u>		
Totals	<u>\$ 14,758,611</u>	<u>\$ 6,078,261</u>	
Net increase in surplus as regards policyholders for the examination			<u>8,680,350</u>
Surplus as regards policyholders, December 31, 2005, per Examination			<u>\$ 35,766,430</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

Based on an analysis by a Casualty Actuary from the California Department of Insurance, the Company's loss and loss adjustment expense reserves as of December 31, 2005 were found to be reasonably stated and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control (Page 6): Amendments to the Federal Income Tax Agreement were made after January 1, 1997 and were subject to the prior approval requirements of California Insurance Code (CIC) Section 1215.5(b)(4). It is recommended that the Company submit the amendments to the CDI for approval.

Corporate Records (Page 6): A review of the board minutes disclosed that, while the officially filed report was presented to the board, the first formally prepared draft by the examiners was not. It is recommended that the Company implement procedures to ensure future compliance with CIC Section 735.

Accounts and Records (Page 9): CIC Section 1100 requires all investments and deposits of the assets of an insurer be made in its own name, or in that of a corporation authorized to act as a trustee under California laws. CIC Section 1104.1 requires that Company assets be deposited in a California custodial account. It is recommended that the Company and its parent comply with CIC Sections 1100 and 1104.1.

Accounts and Records (Page 10): It is recommended that the Company follow up on the corrective actions relating to the Texas Department of Insurance's Examination Report of the Company's parent to insure that they are implemented properly and in a timely manner.

Previous Report of Examination

Reinsurance-Ceded (Page 6): It was recommended that the Company amend its reinsurance agreements to comply with the insolvency clause of California Insurance Code Section (CICS) 922.2. The Company complied with this recommendation.

Accounts and Records (Page 8): It was recommended that the Company maintain documentation to support all financial statement accounts. The Company has complied with this recommendation.

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ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and parent's employees during the course of this examination is hereby acknowledged.

Respectfully submitted,

_____/S/_____
Samuel J. Salzman, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California